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SUBJECT: FRENCH ECONOMIC PERFORMANCE AND REFORM IN 2007

¶1. SUMMARY: The scope of Sarkozy's reform agenda remains ambitious, but despite much jawboning, progress is slow. With weaker than predicated growth and considerable economic uncertainty, reform becomes both more important and more difficult. This cable reviews France's 2007 economic performance and provides an update on Sarkozy's reforms for 2008. End Summary.

2007 ECONOMIC PERFORMANCE

¶2. (U) The Sarkozy government is pursuing its economic reform agenda at a time of softer growth and considerable uncertainty. Initial estimates indicate that the French economy grew by 1.9 percent in 2007, below the government's forecast of 2 - 2.5 percent. GDP growth rebounded in the third quarter reaching an annual rate of 3.2 percent (perhaps showing the "Sarko" effect,) but moderated in the fourth quarter.

¶3. (U) Domestic demand contributed 2.2 percent to 2007's growth with household consumption increasing by 2.0 percent. The French consumer drove the economy in 2007 with purchasing power rising by an estimated 3.3 percent (compared with a 2.4 percent increase in 2006.) Nominal household disposable income rose 4.8 percent, a half point boost over the year earlier, while inflation slowed by a tenth of a point to 1.5 percent. Income tax cuts, and increases in wages, self-employed income and social benefits supported the rise in disposable income. Government consumption increased 1.4 percent, equivalent to 2006.

¶4. (U) Investment growth slowed (3.9 percent compared to 4.1 percent in 2006) mainly due to slower household investment (up 1.3 percent compared to 5.1 percent in 2006). The French were in a wait-and-see attitude before the presidential elections, anticipating tax credits on mortgage interest. Corporate investment did better, rising 5.1 percent (est.) compared to 4.6 percent. However, the national statistical agency, INSEE, detected some year-end weakening in corporate investment as companies reacted to a more uncertain environment by increasing capacity utilization in lieu of expansion.

¶5. (U) The foreign trade contribution to GDP growth in 2007 is estimated at minus 0.3 percent as import growth (4.5 percent est.) slowed compared to 2006 (7.1 percent), but remained higher than export growth (3.6 percent est. compared with 6.3 percent.) Government analysts blame the weak dollar, soft world demand, financial market turbulence and oil prices for the

weaker-than-expected performance. France's trade-in-goods deficit was a record-setting 38 billion euros for the 12 months ending in November 2007. Though the strong dollar is a favorite culprit, Trade Minister Novelli has admitted that structural problems in the French economy are also to blame.

¶6. (U) Higher oil and agricultural prices pushed inflation to 2.4 percent in December 2007 compared with December 2006, up from 1.5 percent the year earlier. Finance Minister Lagarde expects inflation to be higher in 2008. Consumer confidence was at a 19-month low in December, reflecting in part growing concerns over inflation.

¶7. (U) Unemployment declined to 7.9 percent in the third quarter of 2007 from 8.1 percent in the second quarter. Unemployment has continued to decline by an average of 20,000 individuals per quarter, even as economic growth slowed. INSEE estimated that 348,000 jobs were created in 2007 (up from 282,000 in 2006) concentrated in the first half, and in the service and construction sectors. INSEE attributes faster job creation to improved growth in 2006 and 2007 combined with slower gains in productivity.

Update on Reforms

¶8. (SBU) Fiscal Reform: The government's just-release estimate of its summer 2008 tax cut shows significant increases in gift-giving among relatives and in overtime hours worked (20 million more in October alone). The impact of mortgage interest and small and medium-sized companies (SMEs) investment exemptions will be assessed in August. Finance Minister Lagarde is again weighing tax system changes, including a possible "social" value-added tax increase to finance a payroll tax cut.

¶9. (SBU) Budget Balancing: The GOF started the year with a deficit target of 2.5 percent of GDP. Stronger than expected performance pushed the deficit downward despite additional spending and tax cuts

by the incoming Sarkozy government, which were only partly offset on both the expenditure and revenues sides. However, slower economic growth in 2008 may undermine efforts to cut the budget deficit further or even to hold the final estimated 2007 level of 2.3 percent.

¶10. (SBU) Shrinking the civil service: The government plans to cut the size of France's civil service by not replacing one of three retirees in 2008, and one out of two by 2012. Some 22,800 jobs will be eliminated in 2008. Civil service unions are demanding wage increases and an increase in education sector positions, calling a strike for January 24. Some leftist unions disagreed with the government on the new missions of the civil service and the payment of overtime work.

¶11. (SBU) Rationalizing social security: The government objective is to reduce the social security deficit to 8.9 billion euros in 2008 from an expected 14 billion euro deficit if no measures are taken. New limits on reimbursement rates for health procedures were implemented in January. However, hospital practitioners have complained about lack of staff and non-payment of overtime and unused leave backlogs. Health Minister Bachelot is negotiating with unions on payment of leave days or their transformation into pension contributions.

¶12. (SBU) Pension Reform: The government has to plug growing budgetary gaps in the pension system for private sector workers (estimated at 4.7 billion euros in 2007, 8 billion euros in 2010 and 43 billion euros in 2020) by extending the length of service. It also has made a commitment to increase public sector careers to 40 years from 37.5 years starting in 2008. The further lengthening of qualifying service from 40 years to 41 years in both sectors is on the government agenda, but not until after the March municipal elections. The leftist CGT union has showed its opposition in principle to the extension of the pension contribution period. Negotiations on the so-called "special regimes" proceeded on a firm-by-firm and sector-by-sector basis following the strikes of November. The RATP has finalized an agreement, but negotiations

continue at the SNCF and a strike is likely on January 22. The current pay-as-you go system for special regimes has a chronic shortfall (5 billion euros in 2006).

¶13. (SBU) Labor market: Business initially welcomed the Sarkozy government's efforts to gut the 35-hour workweek, but have since complained that the measures are confusing and costly for French companies. The president has also indicated frustration, but backed away from his January 8 statement that 2008 would see the end of the 35 hour work week.

¶14. (SBU) Talks between employers and unions on revising labor contracts to make hiring and firing easier, and to reform the role of unions in negotiating sector-wide agreements, have made some progress, though as of January 11 the CGT has indicated it would not support the existing compromise. If talks break down, the government will introduce a draft law in the National Assembly by early February.

¶15. (SBU) The president's proposal to streamline assistance to job-seekers by merging France's national job placement and unemployment agencies is now before parliament, with the government hoping the bill will be enacted before municipal elections. Agency employees have announced a strike to protest the merger.

¶16. (SBU) Retail Reform: Reform of France's retail market is off to a bad start. A bill adopted by Parliament on December 20 did not liberalize price and margin-fixing rules that govern supplier/retailer relations in France. This does not bode well for the government's other planned changes in the retail sector this year. Planned reforms include lifting restrictions on shopping center construction, allowing retailers to sell at a loss, holding sales throughout the year (which Minister Lagarde has pushed), and opening on Sundays.

¶17. (SBU) Deregulation of the retail sector is proving hard to achieve due to opposition from big name producers such as Danone, L'Oreal and other French "champions" determined to maintain the status quo. In a tactic that has been repeatedly used by this government in the face of opposition, Prime Minister Fillon has asked the former head of France's competition authority, Marie Dominique Hagelsteen, to examine the issue and draft a bill for parliamentary debate in the spring.

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